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No. 237

IN THE

Supreme Court of the United States

OCTOBER TERM, 1958

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,

Petitioner,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA,

and

EQUITY ANNUITY LIFE INSURANCE COMPANY,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., PETITIONER

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Opinions Below

The opinion of the Court of Appeals (R. 885-893)[1] is reported at 257 F. 2d 201. The opinion of the District Court (R. 82-94) is reported at 155 F. Supp. 521, and its Findings of Fact and Conclusions of Law are printed in the record (R. 94-112).

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[1] References to the printed joint appendix and the certified opinion and judgment of the Court of Appeals are indicated as (R.); to additional parts of the record printed pursuant to this Court's Rule 26 as (RS.); and to unprinted parts of the record as (Tr.). Italics are supplied unless otherwise indicated.

Jurisdiction

The judgment of the Court of Appeals was entered May 22, 1958 (R. 895). The National Association of Securities Dealers, Inc. (NASD), intervenor-plaintiff, filed its petition for a writ of certiorari on July 30, 1958. The Securities and Exchange Commission (SEC), plaintiff, filed its petition (No. 290) on August 20, 1958. The petitions were granted October 13, 1958 and the cases consolidated. The jurisdiction of this Court rests on 28 U. S. C. § 1254(1).

Questions Presented

Whether "variable annuity" contracts, which are within the definition of "security" contained in § 2(1) of the Securities Act of 1933, and the issuers of such contracts, which are within the definition of "investment company" contained in §§ 3(a)(1) and (3) of the Investment Company Act of 1940, must be registered under those Acts or whether they are exempt therefrom as "insurance" or "annuity" contracts or "insurance companies" (by virtue of §§ 3(a)(8) and 3(c)(3) of the respective Acts) merely because (a) such contracts have been approved by the Superintendent of Insurance for the District of Columbia and the insurance commissioners of three states (notwithstanding that they lack certain indispensable elements of insurance) and (b) such issuers are chartered as "insurance companies" by the District of Columbia (notwithstanding that their principal business is the sale of such "variable annuity" contracts).

Statutes Involved

Statutes involved are the Securities Act of 1933 (Act of May 27, 1933, 48 Stat. 74, as amended, 15 U. S. C. § 77a), the Investment Company Act of 1940 (Act of August 22, 1940, 54 Stat. 789, 15 U. S. C. § 80a-1) and the McCarran-

Ferguson Act (Act of March 9, 1945, 59 Stat. 33, as amended, 15 U. S. C. §§ 1011-1015). Pertinent provisions of these statutes are set forth in Appendix A, *infra*, pp. 57-66.

Statement

I

The Action

This action was instituted by the SEC to enjoin Variable Annuity Life Insurance Company of America (VALIC) from violating the registration provisions of the Securities Act[1] and the Investment Company Act[2] by offering for sale and selling "variable annuity" contracts. The District Court had jurisdiction of the action by virtue of § 22 (a) of the Securities Act of 1933 (15 U. S. C. § 77v(a)) and § 44 of the Investment Company Act of 1940 (15 U. S. C. § 80a-43).

On their own motions NASD, petitioner herein, and Equity Annuity Life Insurance Company (EALIC) intervened on the sides of the plaintiff and the defendant, respectively.

NASD is a duly organized national securities association registered with the SEC (5 S. E. C. 627 (1939)) exercising powers in the over-the-counter securities market conferred by § 15A of the Securities Exchange Act of 1934, as amended (15 U. S. C. § 78o-3).

In their answers (R. 11-25) VALIC and EALIC admit that they have sold and are selling and offering for sale "variable annuity" contracts through the mails and means

[1] Sections 5(a)(1) and 5(c) of the Securities Act of 1933, 15 U. S. C. §§ 77e(a)(1) and 77e(c).

[2] Section 7 of the Investment Company Act of 1940, 15 U. S. C. § 80a-7.

or instrumentalities of interstate commerce and that they have not complied with the provisions of the Securities Act of 1933 and the Investment Company Act of 1940. They deny that the "variable annuity" contract is a security and that they are investment companies. Affirmatively they plead that: (1) the "variable annuity" contract is "insurance" and an "annuity contract" exempt from registration by § 3(a)(8) of the Securities Act; (2) they are "insurance companies" exempt from registration by § 3(c)(3) of the Investment Company Act; and (3) the offering for sale and the selling of such contracts is "the business of insurance" exempt from Federal jurisdiction by the McCarran-Ferguson Act.

II

The Facts

The material facts are not in dispute and may be summarized as follows:

A

THE HISTORY OF VALIC AND EALIC

VALIC and EALIC are chartered as stock life insurance companies in the District of Columbia.[1] VALIC was first "authorized to transact within the District of Columbia the business of Life Insurance" on April 30, 1956 (Defs. Exh. No. 6, 817, 406).[2]

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[1] EALIC stipulated that its contracts were in all material respects the same as those issued by VALIC (R. 84). In view of this stipulation it is unnecessary to detail the activities of EALIC. When we speak of VALIC in this brief, we include EALIC as well.

[2] Its deposit at that time "for the benefit of all policyholders of the company" consisted "of securities of the par value of $105,000 * * * worth not less than $102,900" (R. 816). Subsequently, on February 27, 1957, the Superintendent certified that VALIC had increased the deposit to "securities, of the par value of $211,000" having a worth of "not less than $200,000" (R. 822).

VALIC was authorized, by administrative action of the respective insurance commissioners, to sell "variable annuity" contracts in West Virginia on August 24, 1956 (R. 823-824); in Kentucky on February 4, 1957 (R. 831-832); and in Arkansas on May 9, 1957 (R. 832-833). In those states in which VALIC has not been licensed "it will also receive and process applications received by mail direct from an applicant" (Pls. Exh. No. 22 (R. 777, 787, 378)).

The principal business of VALIC is the sale of "variable annuity" contracts, which first came into being in 1952 (R. 490).[1]

VALIC and EALIC are the first chartered life insurance companies selling and offering for sale "variable annuity" contracts in the guise of "insurance."

B

VALIC'S "VARIABLE ANNUITY" CONTRACT

VALIC offers for sale and sells to the public numerous types of contracts based on the same investment principle. "Plaintiff's Exhibit No. 1, entitled 'Deferred Variable Annuity Policy', was received in evidence as a specimen of all the contracts that employ such investment practice."[2] It was so considered by the Court of Appeals (R. 889).[3] This contract was analyzed by Mr. Russell Owen Hooker (R. 125-299), who was actuary of the Connecticut State Insur-

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[1] VALIC's expert witness Maclean, an actuary and author of insurance texts (R. 474-477), testified:

"* * * any definition of an annuity promulgated, written, prior to the year 1952, naturally did not contemplate or include within its terms the possibility of a variable annuity" (R. 490).

[2] District Court opinion (R. 84), 155 F. Supp. at p. 523. The exhibit is printed in the record (R. 567-576; admitted in evidence R. 125). VALIC's expert witness testified that all its contracts employed the same investment principle (R. 492-497).

[3] 257 F. 2d at p. 203.

ance Department from 1928 to 1956 and is otherwise well qualified in the field (R. 115-123). His testimony is not controverted.[1]

1. Provisions of the "Variable Annuity" Contract.

The purchaser of a "Deferred Variable Annuity Contract," whom we shall refer to as "the investor" (referred to in the contract as "the annuitant"),[2] agrees to make specified periodic payments to VALIC during a stipulated period from ages 0 to 70 years.[3] After deducting "loading charges" that are retained by VALIC for expenses and profits, the net remaining from each payment is invested by VALIC in a fund for the account of the investor.[4] This fund is exclusively managed, controlled and operated by VALIC. The contract contains no specification of the manner in which VALIC is to invest the capital thus made available to it nor the precise manner in which investment increments, if any, are to be distributed to investors.[5]

At the time of each payment the investor purchases and is credited with a number of shares in the fund (referred to

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[1] In his analysis of the contract Hooker used charts (Pls. Exhs. Nos. 3-A through 3-Q (R. 631-646, 184, 358-360)), all of which cite the provisions of the contract including reference to terms defined and employed therein which are peculiar to it and foreign to "insurance" nomenclature. Statements herein with reference to the provisions of the contract are supported by this testimony.

[2] Pls. Exh. No. 1 (R. 567).

[3] Pls. Exh. No. 1, "Premiums" (R. 567), and par. 5(d) (R. 570); Pls. Exh. No. 2, being VALIC's "General Information and Rates" book (R. 579 at pp. 615-627, 126).

[4] Pls. Exh. No. 1, par. 4 (R. 568). See also undisputed expert testimony detailing how this is accomplished by operation of the contract's provisions (R. 134-163).

[5] Hooker testified:

> "It should be noted that the contract is not specific as to the presumption of accrual basis for income, nor as to investment expense, nor as to how the denominator [value of assets invested or available for investment] of the [gross investment] rate is to be calculated. It [the contract] says, 'Determined each month from the total investment experience of the Company.'
>
> "It would seem that the Company has some latitude, according to the contract, according to my analysis of it, in determining just what should go in there" (R. 138).

in the contract as "accumulation units"),[1] determined by dividing the current value of a share at the time of payment into the net payment.[2] The value of the shares fluctuates with VALIC's investment experience. The contract provides that at least once each year VALIC shall notify each investor of the total number of shares ("accumulation units") credited to his account and the dollar value of each share as of the date of notification.[3]

Throughout the period during which the investor makes periodic payments (referred to herein as the "accumulation period") he may at any time cash in his shares at current value (this the contract calls "cash value") as a result of which he may realize a profit or loss.[4] During this same period the investor may cash in a portion of his shares at current value (this the contract calls a "policy loan").[5] If he reinvests (repays) what the contract terms a "policy loan" he is not necessarily credited with the same number of shares he cashed in. Instead, his "repayment" purchases shares at their current value as of the date of "repayment." Thus the investor may on "repayment" acquire a greater number of shares than he would have had if he had not entered into the "loan" transaction, or a lesser number.[6] This is in contrast to true insurance policies or annuity contracts which set forth and guarantee *fixed* "cash values" and "loan values."[7]

During this period the investor may also speculate by taking advantage of the so-called "Grace Period"[8] and by

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[1] Pls. Exh. No. 1, par. 4 (R. 568).
[2] Expert testimony (R. 134-163).
[3] Pls. Exh. No. 1, par. 4(c) (R. 568). A copy of such a notification is in evidence (Pls. Exh. No. 18 (R. 743, 367)).
[4] Pls. Exh. No. 1, par. 14 (R. 572) and expert testimony (R. 168-171).
[5] R. 163-166.
[6] Pls. Exh. No. 1, par. 15 (R. 572) and expert testimony (R. 163-166).
[7] R. 123-124, 452, 498, 544, 556.
[8] Pls. Exh. No. 1, par. 2 (R. 568).

making payments "on or before" the due date[1] provisions of the contract. VALIC establishes the dollar value of a share ("accumulation unit") as of the last day of each month.[2] If the investor is of the opinion that the dollar value of a share will decrease by the end of a given month he can withhold his payment until the next month. If he guesses right he will receive more shares for the same payment. If he thinks the dollar value of a share will increase in the future he can make advance payments and purchase shares at current value.[3]

VALIC's expert witness, Maclean, testified that VALIC's operations during the accumulation period are similar to those of an investment company.[4]

Throughout the period during which the investor is making payments to VALIC there is no life or other insurable contingency involved.[5] The investors provide the capital, share in the earnings and profits, and bear the risk of loss resulting from investment of their funds by VALIC.[6]

By contrast, investment and mortality prognostications are used by an insurer to fix its selling price. The risk that premium rates so fixed may prove to be inadequate is borne by the insurer; and, should that result come about, it does not affect the contractual obligation of the insurer to the insured upon the occurrence of the insurable contingency.[7]

The "variable annuity" contract does not obligate the investor to participate in the investment fund to any fur-

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[1] Pls. Exh. No. 1, "Premiums" (R. 567).
[2] Pls. Exh. No. 1, par. 19 (R. 573).
[3] Findings of Fact, No. 48 (R. 108); expert testimony (R. 150-151).
[4] R. 492-493.
[5] R. 189-190, 245, 494.
[6] R. 163, 545; Findings of Fact, Nos. 49, 94 (R. 108, 111).
[7] R. 163, 438, 461.

ther extent than that set forth above. It does give the investor an *election* to take cash or to purchase a so-called "variable annuity" between the ages of 50 and 70 years.[1] If he *elects* the "variable annuity," he makes a "capital payment" (R. 254) to VALIC computed by multiplying the number of shares ("accumulation units") credited to his account times the current value of a share. For each $1000 of this payment VALIC pays him a *first* monthly payment of less than $10 per thousand, computed on the basis of the Progressive Annuity Mortality Table at 3½% interest (R. 175-178).[2] In a true annuity contract computed on the same basis the *same* monthly amount, guaranteed at the inception of the contract, would be paid to the annuitant for the entire term (R. 177-178, 452).

After the *first* monthly payment the investor is assured no specific, *or even any,* subsequent monthly payments during the term of the contract. Instead, he is credited with a number of shares (called "annuity units") in the investment fund (R. 178-182).[3] The future value of these shares ("annuity units") is speculative in that *all* monthly payments, *if any,* subsequent to the first, are computed by

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[1] Pls. Exh. No. 1, par. 5(d) (R. 570); expert testimony (R. 494). Pls. Exh. No. 2 (R. 603).

[2] From the inception of the contract up to the date of election the investor cannot know what capital he will have acquired, for he cannot foresee how many shares ("accumulation units") he will have purchased or their value as of the date of election (R. 160-161). Since, as admitted by VALIC's actuary and a member of its Board of Directors (R. 521-526), VALIC does "not guarantee the investment experience" (R. 545), it stands legally indifferent whether the value of the shares held by the investor at the date of election is more or less than the total amount invested. The investor has only the hope that VALIC's management, operation and control of the investment fund in which he has an aliquot share will result in a profit and not a loss.

[3] Numbers of "annuity units" credited to the purchaser's account is determined by dividing the first month's guaranteed payment by the current value of such unit. The number of units remains constant for the balance of the term of the contract (R. 175-182). One who elects to purchase a "variable annuity" contract when the value of an "annuity unit" is low will have more such units credited to his account than another making the same capital investment under the same contract when the value of the unit is high. The former, owning more shares, will receive larger payments than the latter in the same month (provided each unit has some value) although each has invested an identical amount of dollars.

the formula number of shares times the current monthly value of a share resulting from VALIC's operation, management and control of the investment fund (R. 496-497). Before the investor's interest can be known, VALIC deducts, as a prior charge, a management fee (1.8% per annum),[1] and investment taxes (undescribed in the contract and of uncertain amount).[2] The investor is paid each month for life, or other optional term, the uncertain future current monthly value, *if any*, of a share ("annuity unit") times the number of shares credited to his account. VALIC is legally indifferent what the value of a share, each month, may prove to be. The contract does not *assure* the investor that he will have a fixed dependable income, or any income, for the remainder of his life. Instead, he has only the hope of gain and bears the risks of loss resulting from VALIC's exclusive management, control and operation of the investment fund.

2. Insurance Benefits, If Included in the "Variable Annuity" Contract, Are *De Minimis*, Separate and Severable

VALIC requires that the purchaser of a deferred "variable annuity" contract, *if insurable* and within certain age limits, purchase a contract for 5-year decreasing term life insurance. Its "General Information and Rates" book states:[3]

> "All individual deferred annuity policies will be issued with a minimum amount of life insurance on the annual decreasing term plan unless the applicant fails to meet the Company's insurability requirements. In the case of *annual* premium policies, the initial amount of insurance in the first policy year will be equal to five times the annual basic annuity premium. In the case of *single* premium policies, the amount of

[1] R. 138-139, 546-551.
[2] R. 136-137; Pls. Exh. No. 1, pars. 18-22 (R. 573).
[3] Pls. Exh. No. 2 (R. 579 at p. 583).

life insurance in the first policy year will be equal to one-half of the single premium. In both the annual and single premium cases, the amount of insurance will decrease one fifth each year until at the end of the fifth year it will be zero.

* * *

"* * * Individual policies without life insurance will be issued to: (1) applicants from age 61 to 70, inclusive; and (2) from age 0 to 60 on uninsurable applicants."[1]

An investor may also *elect* to have included in his contract as a rider "A total and permanent disability premium waiver benefit."[2]

It is conceded that the 5-year decreasing term life insurance and the total and permanent disability premium waiver benefit are true insurance. But VALIC sells the bare "variable annuity" without such insurance.[3]

In those cases where the investor satisfies medical requirements and purchases one or both of the aforementioned types of insurance, the premium for the coverage is deducted from the amount he would otherwise have available for purchases of shares ("accumulation units") after VALIC has deducted its loading charges. Compared to the total payments made by the investor this amount is *de minimis*. In the case of the specimen contract,[4] which provides for the investor's payment of $1000 per year to VALIC, the cost of the 5-year decreasing term life insurance over the 5-year period would be $100.85, equal to a little over 2% of the total payments of $5000; and if the contract remained in force for 30 years of payments by the investor, out of total payments amounting to

[1] Pls. Exh. No. 2 (R. 579 at p. 586).
[2] Pls. Exh. No. 2 (R. 579 at p. 584).
[3] Testimony of VALIC's president (R. 517). In its reply brief filed in the District Court VALIC said (p. 24): "If VALIC sold no contract except deferred life annuity policies—if it offered no term insurance or premium waiver—it would be engaged solely in the life insurance business * * *."
[4] Pls. Exh. No. 1 (R. 567).

$30,000 only $100.85 or 3/10 of 1% would be applied to life insurance premiums.[1] The disability premium is $39.60 per annum.[2]

Of the decreasing term life insurance in force on December 31, 1956, 91.4% was reinsured by VALIC in another company; and of the disability insurance in force on the same date, 89.5%.[3]

VALIC's book "General Information and Rates" indicates that it offers, at the option of the purchaser of a "variable annuity," additional term insurance (Pls. Exh. No. 2 (R. 579 at pp. 583-584)). There is no evidence that VALIC has ever sold such insurance.

The District Court found that "The distinguishing and predominant nature of a variable annuity is found in its provision for sharing profits and losses in a common fund to be invested mainly in common stocks."[4] The Court of Appeals found that the life insurance contracts sold by VALIC "are a small part of its total business" and are "irrelevant to the question of the nature of the predominant annuity feature of the policy."[5]

3. The Format of and Terms Used in VALIC's "Variable Annuity" Contract

VALIC's "variable annuity" contracts are printed in a format usually associated with insurance contracts.[6] Found in them are insurance terms such as "cash value" and "loan value," but by definition therein they differ from and are at variance with the usual insurance meaning of the terms. Also found in the contracts are insur-

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[1] R. 126-132, 161-162.
[2] R. 132, 162.
[3] R. 186-188.
[4] Findings of Fact No. 94 (R. 111).
[5] 257 F. 2d 201, 203 (R. 888-889).
[6] Pls. Exhs. Nos. 1 (R. 567), 7 (R. 677), 8 (R. 681), 9 (R. 685), 10 (R. 689), 11 (R. 701) and 12 (R. 713).

ance terms such as "The Death Benefit," "The Beneficiary," "Grace Period," "Protection from Creditors," "Incontestability," "Suicide." Most of these can apply only to the 5-year decreasing term life insurance (*if* included in the contract) and are not relevant to the "variable annuity" provisions of the contracts.[1]

The terms in the contract which are the vitals of its so-called "variable annuity" are "gross investment rate," "net investment rate," "net investment factor," "accumulation unit," "value of an accumulation unit," "annuity unit," and "annuity unit value." These terms are not found in insurance nomenclature. VALIC's own actuary, a member of its Board of Directors, who said he had been retained by some 150 insurance companies, testified that other than in the VALIC and EALIC contracts he had never seen such terms in an insurance contract.[2]

C

VALIC'S SALES LITERATURE COMPARED WITH ITS "VARIABLE ANNUITY" CONTRACT

We respectfully suggest that the Court read VALIC's sales literature.[3] Only by observation of the typographical composition of the literature is its full import revealed. This Statement of Facts cannot reflect the emphasis attained by type and spacing employed; or qualification of apparent guarantees by the use of fine print.

This sales literature shows that VALIC seeks to impress upon prospective purchasers of its so-called "variable annuity" contracts that it is selling:

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[1] "Cash value," "loan value" and life insurance benefits, *if any*, apply only to the period during which the investor is making payments to VALIC. They have no application to the "variable annuity" period (R. 175).

[2] R. 554-555.

[3] Pls. Exhs. Nos. 19 (R. 745-758, 378), 20 (R. 761-767, 378), 21 (R. 769-776, 378), 22 (R. 777-789, 378), 23 (R. 793-794, 378) and 24 (R. 795-804, 378).

(a) "RETIREMENT WITH PROTECTED PURCHASING POWER" (R. 745);
(b) "INFLATION-PROOF ANNUITIES" (R. 761);
(c) Insurance against loss resulting from increase in the cost-of-living;
(d) An interest in a common-stock fund.

The following are a few excerpts that are typical of the tenor of the VALIC sales literature:

1. *Pls. Exh. No. 19* (R. 745):

"* * * a search was made for an anchor *to assure* purchasing power against fluctuations in the dollar value" (R. 749).

"* * * a way to provide *inflation-proof* retirement was found" (R. 749).

In stating the difference between a "variable annuity" and a conventional annuity:

"This difference is created by the investment by VALIC of a substantial amount *of your money* in business equities rather than in debt securities" (R. 750).

"The VALIC Plan, as we have said, is the means by which you can *assure* a comfortable inflation-proof old age * * *" (R. 754).

2. *Pls. Exh. No. 20*, blazoned with the caption "INFLATION-PROOF ANNUITIES" (R. 761), states that the "annuity payments * * * *will increase* in amount during an inflationary period" (R. 767).

3. *Pls. Exh. No. 21* unequivocally states that the purchaser's money is invested in common stocks (R. 772, 774). It also states that the contract holder's "proportionate ownership" in the fund is reflected by the shares which he purchases, the shares being called "units" (R. 774).

4. *Pls. Exh. No. 22* under the caption, "WHAT ARE THE ADVANTAGES OF THE VALIC PLAN?" (R. 781):

"The principal advantages of the VALIC Plan are as follows:

It provides an annuity income that cannot be outlived.

It *will reflect* the traditionally higher yields of equity investments.

It *will provide* an income which will tend to keep pace with the cost of living.

The VALIC PLAN *guarantees* that the policy holder will receive payments as long as he lives * * * [O]nly variable life annuities * * * can provide a life annuity based on * * * equity investments" (R. 781).

5. *Pls. Exh. No. 23:*

"Find out about variable annuities—*that provide retirement with protected purchasing power*" (R. 793).

EALIC, which stipulated that its "variable annuity" contracts were in all material respects the same as VALIC's, in a brochure "EQUITY ANNUITY—a new road to SECURITY," described the scheme (Pls. Ex. No. 17, RS. 899, Tr. 562)[1]:

"Our variable annuity program is designed to minimize the speculative features of common stock investments. You avoid the gamble of buying a single stock * * * [T]he company 'spreads the risk' by buying stocks in *many* of the nation's leading corporations * * * You avoid the risk of buying stocks at one point in the stock market * * * You avoid buying stocks on a 'hot tip'. Instead you benefit from the counsel of expert financial advisers * * * in short you get the benefit of expert diversification."

Pls. Exh. No. 19 (R. 745, 752-753) is an example of VALIC's sales techniques. Using two stock price indices entirely unrelated to VALIC activity ("Standard and Poor's Weekly Composite Index of 480 stocks for price and Standard and Poor's Daily Composite Index of 90

[1] RS. 899 refers to the record as reprinted under the supervision of the Clerk of this Court. It is p. 910 of the certified record.

stocks for yield''), VALIC presumes to show the prospective purchaser how he would have benefited had he invested in a "variable annuity'' instead of a conventional annuity during the period 1940-1955. The tables and graph set forth in the exhibit are based, not upon the experience of VALIC, but upon stock market averages of securities differing substantially from VALIC's portfolio.[1] VALIC obviously uses this technique to imply future results.

A comparison of the sales literature's statements and implications as to what the "variable annuity'' contract provides and the actual provisions of the contract[2] reveals that the contract does not insure "Retirement with Protected Purchasing Power,'' or against losses resulting from inflation or increase in costs of living, or "an annuity income that cannot be outlived.'' It does not even mention these objectives.[3] The only guarantee in the contract is a *first* monthly payment of less than $10 for each $1000 of capital payment (the amount of which is unforeseeable until the month of election). Every provision for subsequent monthly payments by VALIC is conditioned on its investment experience.

The contract does state that "The Company guarantees that the dollar amount of such installments after the first [monthly payment] shall not be affected by variations in the actual mortality experience of payees from the mortality experience assumptions of the Progressive Annuity Mortality Table.'' This is meaningless. The contract itself explicitly obligates VALIC to pay to each investor, for the term of his contract, an amount equal to the product of the current value of each "annuity unit''

[1] Defs. Exh. No. 38 (R. 849-850, 513).
[2] Pls. Exh. No. 1 (R. 567-576).
[3] While "inflation," with its attendant increase in the cost of living and depreciation in the value of the dollar, may be an insurable contingency, the "variable annuity" contract does not indemnify or guarantee against loss therefrom.

times the number of such shares credited to his account. It follows that the quoted reference to mortality is a mere redundancy because experienced departures from the expected mortality, whether in the direction of longer or shorter life, could have no effect on the operation of the basic formula which describes VALIC's obligation to pay under its contract.[1]

D

OPINIONS OF THE LOWER COURTS

1. The District Court

The District Court found that:

> "74. A VALIC and an EALIC contract holder invests money with the respective defendants with the hope or expectation that a profit will accrue to him as a result of the management of the portfolio of securities purchased by VALIC and EALIC with the money invested by the contract holder, and his expectation of profit based upon the efforts of others applies to both the 'accumulation period' and to the repayment or variable annuity period" (R. 109-110).
>
> "49. The risk of profit or loss on investment is borne by the contract holders" (R. 108).
>
> "94. The distinguishing and predominant nature of a variable annuity is found in its provision for sharing profits and losses in a common fund to be invested mainly in common stocks" (R. 111).
>
> "93. The insurance features of such contracts do not alter the investment characteristics" (R. 111).

In its opinion the District Court stated that "[t]he logic of the law applied to the established facts seems to bring the variable annuity contract within the purpose and intendment of the Securities Act, and the defendants within the terms and plans of the Investment Company Act" (R. 89).

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[1] Pls. Exh. No. 1, pars. 20-22 (R. 573).

It so found as a conclusion of law (R. 112). Without making a finding that the "variable annuity" contract is "insurance" and its sale "the business of insurance," the District Court denied the injunction because: (1) VALIC was chartered as an insurance company; and (2) its "variable annuity" contracts had been approved by the Insurance Superintendent of the District of Columbia and by the insurance departments of three states (West Virginia, Kentucky and Arkansas). From this premise the court reasoned that the provisions of the McCarran-Ferguson Act exempted the contract and its sale from compliance with the Federal securities laws (R. 90-91, 112).

2. The Court of Appeals

On appeal none of the parties excepted to the trial court's Findings of Fact.

The Court of Appeals said that:

> "* * * the most important risk that the purchaser desires to shift when he buys an annuity is the risk that he will live longer than his funds will last."[1]

It then went on to show that the risk is *not shifted* by the "variable annuity" contract by saying:

> "The appellants urge that VALIC policy holders, like investors in investment companies, may lose their savings and ultimately fail to receive the protection which they hope to buy when they paid their premiums. That fact seems to us to be inherent in the nature of this experiment in annuity contracts."[2]

In affirming the District Court, in an opinion unsupported by reference to case law or other authorities, the Court of Appeals failed to find or hold that the "variable annuity" contract is "insurance" or an "annuity." It found that the sale of "variable annuity" contracts is a "novel" ar-

[1] 257 F. 2d at pp. 204-205 (R. 892).

[2] 257 F. 2d at p. 205 (R. 892). *Cf.* VALIC's sales literature, which emphasizes the hope of speculative gain. *Supra*, pp. 13-16.

rangement, a "new business" which "resembles insurance."[1] Paying no heed to the substance of the contracts, the court attached controlling weight to approval of the contracts by the Superintendent of Insurance for the District of Columbia and the insurance commissioners of three states.[2] It did not indicate that it had given consideration to the expert opinion of the SEC that the contracts are securities. Instead of adjudicating the legal issue presented as to whether the contracts are in substance a "security" or "insurance" the court supported its conclusion on its assertion that there is an economic need for such contracts, and that "The definitions in the Securities Act and the Investment Company Act indicate that if the insurance commissioner of a state subjects the business to his supervision, it is the business of insurance."[3]

Summary of Argument

I. "Variable annuities" are "investment contracts" which are defined as "securities" by the Securities Act of 1933. Members of the public who purchase these contracts participate in a typical investment scheme: they hope to gain through investment of their funds by respondents, but they alone bear the risk of loss. Respondents do not assume any part of that risk. They only invest the buyers' contributions in common stocks, hoping to increase the value thereof for account of the buyers. This is true during the "annuity period" as well as the "accumulation period." This arrangement exactly meets the test of an "investment contract" laid down by this Court in *SEC v. W. J. Howey Co.*, 328 U. S. 293, 301 (1946): "The test is whether the scheme involves an investment of money in

[1] 257 F. 2d at pp. 204-205 (R. 890, 893).
[2] 257 F. 2d at pp. 204-205 (R. 891, 893).
[3] 257 F. 2d at p. 205 (R. 892).

a common enterprise with profits to come entirely from the efforts of others." Being securities, "variable annuity" contracts are subject to the registration requirements of the Securities Act.

II. Respondents are "investment companies" subject to the registration requirements of the Investment Company Act of 1940 because they are primarily engaged in investing, reinvesting, holding and trading in securities consisting mainly of common stocks which in value exceed 40% of respondents' assets.

III. The Securities Act of 1933 and the Investment Company Act of 1940, therefore, extend to respondents and the contracts they sell unless they are specially exempt from compliance. Respondents claim such exemption on the ground that they are "insurance companies" under the Investment Company Act, that "variable annuities" are "insurance" and "annuity contracts" under the Securities Act and that the business of selling them is "the business of insurance" under the McCarran-Ferguson Act. These arguments are without merit because, *inter alia:*

A. The word "insurance" in the exemptive portions of these statutes is used in its commonly accepted sense. In this sense "risk-shifting"—the shifting from the insured to the insurer of a risk of loss occasioned by the happening of an insurable contingency—is an indispensable element of the "insurance" concept. *Helvering v. Le Gierse,* 312 U. S. 531 (1941). "Variable annuities," however, embody no risk-shifting whatever. The risk of excessive longevity—which is insured against by an ordinary annuity—is not shifted to the issuers of "variable annuities," but remains on the shoulders of the contract holders because the issuers make no guarantee of *any* return

to them. Reference to or employment of insurance terminology, forms and tables in the contracts cannot make them "insurance" contracts in the absence of risk-shifting.

B. Approval of "variable annuity" contracts by four local insurance commissioners is without significance. There is no indication that Congress intended to authorize local insurance officials to determine the applicability of the Federal securities laws. Any such power would result in lack of uniformity and would defeat the congressional purpose in enacting those laws.

IV. "Variable annuities" are not "annuities." The essence of an "annuity" is periodic payment of a *fixed* sum. Payments under "variable annuity" contracts are by definition *not* fixed; instead they rise or fall depending on earnings or profits. *Booth v. Ammerman*, 4 Bradford Surr. 129 (N. Y. 1856); *Spellacy v. American Life Ins. Ass'n*, 144 Conn. 346, 131 A. 2d 834 (1957).

V. The exemption of the McCarran-Ferguson Act is expressly limited to "the business of insurance." The term "the business of insurance," as used in that Act, is used in its "commonly accepted sense." If "variable annuity" contracts are neither "insurance" nor "annuities," respondents' business of selling them is not "the business of insurance."

VI. The courts below misapplied the exemptive provisions of the controlling statutes because they failed to recognize that "variable annuities" lack the indispensable risk-shifting element of "insurance." The statutory exemptions do not apply to any contract that lacks this element.

VII. The Court of Appeals indicated that the possible economic value of "variable annuities" was a reason for affirmance. Such value is irrelevant. "Variable annuities," whether economically sound or not, can be sold under Federal securities regulation.

ARGUMENT

I

Respondents are Primarily Engaged in the Business of Selling to the Public Investment Contracts Defined by Law as Securities That Must be Registered Under the Securities Act of 1933

Respondents are in the business of selling investment contracts; those contracts are "securities" as defined by § 2(1) of the Securities Act of 1933; and those securities must therefore be registered under §§ 5 and 10 of the Act.[1]

Respondents' claim of exemption from the registration provisions of the Act by virtue of § 3(a)(8) thereof is discussed in subsequent portions of this brief.

A

Respondents Are Primarily Engaged in Selling Investment Contracts Known as "Variable Annuities"

The primary business conducted by respondents is selling "variable annuities" to the public. These contracts have been described above at length.

The contract disclosed by the evidence has every usual characteristic associated with an investment contract under

[1] The Securities Act of 1933, 48 Stat. 74, appears in the Code as 15 U. S. C. §§ 77a-77aa. The sections referred to above are designated in the Code as follows: § 2(1), § 77b(1); § 5(a), § 77e(a); § 10, 77j (Appendix A, *infra*).

the Securities Act of 1933 as well as in common understanding. If this device is not an investment contract, then the concept is hardly susceptible of practical application to anything that does not already bear the label. The Uniform Securities Act, already adopted in some states, treats "variable annuities" as securities and does not exempt them from blue sky regulation as insurance. See Loss & Cowett, Blue Sky Law (1958) 350, 356-357.

One fundamental distinction between a contract of investment and a contract of insurance lies in the incidence of risk. In an investment contract the investor takes the risk that at some time in the future the value of his investment will decline or disappear. In insurance and conventional annuities, however, this risk is shifted to the company, which guarantees the insured payment of a specific sum on the happening of an event or events—such as survival from month to month after attainment of retirement age—without reference to the losses it may suffer upon investment of the premiums paid in.

The risk of loss that is inseparable from investment is accompanied, of course, by the chance of gain. An investment such as a common stock may appreciate in absolute value over the holding period. Insurance does not provide this chance. When an insured or an annuitant shifts his risk of loss to the insurance company, he also gives up this chance of gain.

What of a "variable annuitant"? As the District Court found, he makes payments to one of the respondents "with the hope or expectation that a profit will accrue to him as a result of the management of the portfolio of securities purchased" by the company with his money and that of other "variable annuitants." This hope or expectation

of profit exists throughout both the accumulation period and the "variable annuity" period. The "variable annuitant" always bears the risk of loss. The respondents do not take any part of that risk: like managers of investment companies, they are without legal responsibility to the "variable annuitants" for any investment, reasonably prudent when made, that happens suddenly to go bad. They cannot be held accountable for any losses to "variable annuitants" that stem from sudden drops in equity values caused by war, deflation, executive heart attacks, or any of a thousand other unforeseeable events that affect security values.

Finally, the hope of gain that is entertained by people who buy respondents' "variable annuities" rests solely on the hope that the gain will arise from respondents' skillful management of the security portfolio bought with the "variable annuitants'" money. The investors have no voice in the companies' investment policy. That is the sphere of the promoters. The people who put up the money must rely on the efforts and ability of respondents to produce their profits or limit their losses.

Exactly these considerations have been relied on by the courts in holding other and similar devices to be "investment contracts" within the meaning of § 2(1) of the Securities Act. The leading case is *SEC v. W. J. Howey Co.*, 328 U. S. 293 (1946). There a group of promoters offered to the public interests in land planted to citrus trees. Together with these interests they offered service contracts whereby the promoters undertook, for a fee, to cultivate each "landowner's" trees and harvest and market his crop, remitting the net profits to him. The "landowners" there, like the "variable annuitants" here, were people looking for a common enterprise managed by experts in

which they could put their money and from which they might realize profits. The Court held that they had bought "investment contracts" as that term is used in § 2(1) of the Securities Act of 1933, saying:

> "Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed" (328 U. S. at p. 300).

Speaking more broadly, the Court laid down a rule applicable to all such situations:

> "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others * * * The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae" (328 U. S. at p. 301).

The trappings of "land ownership" surrounding the *Howey* scheme did not blind this Court to its substance as an investment contract and registerable security. The trappings of "insurance" and "annuities" that adorn the scheme contrived by respondents should likewise fail to mislead this Court. To the extent that "variable annuities" masquerade as "insurance" or "annuities," therefore, they are a sham. They should be treated as other investments are.[1]

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[1] In the lower courts VALIC has consistently cited *Haberman v. Equitable Life Insurance Soc'y.*, 224 F. 2d 401, reh. denied, 225 F. 2d 837 (5th Cir. 1955), *cert. denied*, 350 U. S. 948 (1956), in support of its argument that the "variable annuity" is not a security. That case was concerned only with whether a *true* annuity is a security under Texas law and it was held not to be. The case is inapposite to the issue in the instant case since § 3(a)(8) of the Securities Act of 1933 exempts *true* annuities from the provisions of that Act. As shown *infra*, the "variable annuity" is not an "annuity."

B

The "Variable Annuity" Investment Contracts Sold by Respondents Are Securities That Must Be Registered Under the Securities Act of 1933

Section 2(1) of the Securities Act defines a "security" as, *inter alia*, "any * * * certificate of interest or participation in any profit-sharing agreement [or] investment contract * * *." Any "security" so defined must be registered under §§ 5 and 10 of the Act before it can be offered for sale or sold to the public.

In the *Howey* case this Court held that the citrus grove device described above was a "security" within the terms of § 2(1) because it was an "investment contract" and therefore had to be registered, like other securities, for the protection of the public. Additional authority is hardly necessary; but there are a number of decisions to the same effect. See, *e. g.*, cases cited in Loss, SECURITIES REGULATION (1951) 318, where the author comments on the *Howey* case:

> "A great many other schemes—many of them of the Alice in Wonderland variety—have been brought under both federal and state umbrellas by this same process of looking through form to substance."

Twenty-five years ago Congress determined that the welfare of the public demands full and fair disclosure of all material facts concerning securities to be offered through the mails or in interstate commerce. It forbade material misrepresentations, even innocent ones, about such securities. Securities are purchased with the expectation of gain through another's efforts and skill, but ownership is always accompanied by the risk of loss. The business of selling them is one that too easily lends itself to misrepresentations. Unless this business is policed, the possibility

of profit tends to be emphasized and the risk of loss minimized by the natural cupidity of buyers and the equally natural desire of sellers to make sales (to say nothing of naive buyers and venal sellers).[1] Congress elected to base this policing on the requirement of registration under the Securities Act. Without full and fair disclosure there can be no registration, and without registration there can be no public offering or sale. This "disclosure regulation" under the Securities Act has worked so well and "with such salutary and beneficial results" that it "has been one of the significant developments of our time." *United States v. Morgan*, 118 F. Supp. 621, 646 (S. D. N. Y. 1953).

C

"Variable Annuities" Are Not Exempt From Registration as Being "Like" Insurance or Annuity Contracts Under § 3(a)(8) of the Act

Section 3(a)(8) exempts from the registration requirement of the Securities Act insurance or endowment policies or annuity contracts.

The House Report on the bill that became the Securities Act comments briefly on this exemption by noting that it

> "* * * makes clear what is already implied in the act, namely, that insurance policies are not to be regarded as securities subject to the provisions of the act. The insurance policy and like contracts are not regarded in the commercial world as securities offered to the public for investment purposes." H. R. Rep. 85, 73d Cong., 1st Sess. (1933) p. 15.

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[1] "* * * it is rather unrealistic to expect that the dealers, people who have something to sell, are not going to puff their merchandise when they sell * * * [T]he concept of a reluctant salesman is just about as visionary as that of a nation without a thirst." Hearings before the House Committee on Interstate and Foreign Commerce on H. R. 7550 and S. 2846 (to amend the Securities Act), 83d Cong., 2d Sess., p. 104 (1954) (testimony of Louis Loss).

In subsequent portions of this brief we will show that "variable annuities" are not insurance or annuities. Can a "variable annuity" contract be considered "like" an ordinary insurance or annuity contract? Certainly it was not so considered in 1933, for it did not then exist: it is a "novel" investment scheme concocted in 1952, seeking to assimilate by a qualifying adjective ("variable") an honorable name ("annuity") to which it is not entitled. But even if it had existed when the statute was passed, there could hardly have been any serious claim that it should be exempt from registration because it was "like" contracts providing insurance and annuities. The "variable annuity," as we have shown, is a vehicle for speculation in which all the risks of property ownership fall on the buyer, though all the "management" incidents of ownership (including management fees) are reserved to the promoters. Insurance and annuity contracts contain no element of speculation; they *guarantee* a definite return; and the risks of property ownership involved are borne exclusively by the issuing companies, which are required by law to possess a "reserve" to meet the guarantees which they make upon assuming the risk shifted to them. The "likeness," then, is exclusively verbal.

In any event, it is inconceivable that the 73d Congress, determined to stop the speculative abuses that had contributed to the great depression of the thirties, would have exempted from the "disclosure act" a scheme furnishing the public an opportunity to invest in common stocks and to win or lose depending on a combination of luck and the skill of the promoters. The "variable annuity" is the very kind of investment medium Congress aimed at when it adopted the Securities Act. To exempt this scheme because it wears the "annuity" label would sacrifice substance to form and frustrate the congressional purpose.

II

Respondents Are "Investment Companies" Under the Investment Company Act of 1940 and Must Register as Such

The Securities Act emphasizes protection of investors and the public interest at the moment securities are offered. The Investment Company Act extends that protection, in certain investment situations, after the sale has taken place. The respondent companies are subject to the latter as well as the former.

Like the Securities Act, the Investment Company Act is concerned with substance rather than form. The Act defines an "issuer" as "every person who issues or proposes to issue any security, or has outstanding any security which it has issued" (§ 2(a)(21), 15 U. S. C. § 80a-2(a)(21)). And an "investment company" is defined by the Act as an issuer that is

> "(1) * * * engaged primarily * * * in the business of investing, reinvesting, or trading in securities"
>
> *or*
>
> "(3) * * * engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) * * *."[1]

An issuer conforming to these descriptions, even one chartered as an insurance company, if it is not in fact an "insurance company" as defined in § 2(a)(17) of the Act, much register with the SEC as an investment company under § 8 of the Act (15 U. S. C. § 80a-8) and obey the

[1] These definitions of an "investment company" are contained in §§ 3a(1) and 3a(3) of the Act, respectively, 15 U. S. C. §§ 80a-3a(1) and (3) (Appendix A, *infra*).

other provisions contained therein designed to protect buyers and holders of its securities and the public interest.

Manifestly the respondents are engaged in the business of investing, reinvesting, owning, holding and trading in securities. Their skill in investing so as to defeat the effect of inflation, indeed, is the essence of their "sales pitch". They have retained an investment adviser to help them (R. 513). Investing and trading in securities is their principal business, for they do virtually nothing else (except sell to the public shares in their investment pool). But it is not even necessary to quibble about whether investing is their "primary" business, because far more than 40 per cent of their assets are, or are proposed to be, in common stocks, which would bring them within part (3) of the quoted definition even if their admitted "investing" was not their "primary" business.

Respondents' claim to be exempt from the requirements of this Act is analyzed *infra*.

III

Risk-Shifting is an Indispensable Element of "Insurance" in its Commonly Accepted Sense

The foregoing discussion shows that "variable annuities" and their issuers are subject to registration in the public interest unless specially exempted. The pivotal issue in this case, therefore, is whether the "variable annuity" contract is "insurance" within the meaning of that term as employed in the exemption provisions of the Securities Act of 1933 (§ 3(a)(8)),[1] the Investment Com-

[1] See. 3(a)(8): "Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia."

pany Act of 1940 (§ 2(a)(17)[1] and § 3(c)(3)), and the McCarran-Ferguson Act.[2] The term "insurance" is not defined in any of these Acts or their legislative histories. There are no reported cases in which the meaning of the term in any of the Acts is construed. Necessarily, then, the language and purpose of the Acts are virtually the only basis for determining what the Congress intended to exempt. Under such circumstances, this Court has held that the term "insurance" must be taken to have been used in a statute in its "commonly accepted sense."[3]

A

The "Commonly Accepted Sense" of the Term "Insurance"

This Court has already construed the meaning of the term "insurance" when used by the Congress in a statutory enactment without definition. In so doing it said:

> "Historically and commonly insurance involves risk-shifting and risk-distributing. * * * That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators."[4]

The same conclusion was reached by the Court of Appeals for the District of Columbia Circuit in another leading case which reviewed and analyzed a multitude of authorities. In construing the meaning of the term "insur-

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[1] Sec. 2(a)(17): "'Insurance company' means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such."

[2] This Act exempts only "the business of insurance" from Federal regulation.

[3] *Helvering v. Le Gierse*, 312 U. S. 531, 540 (1941).

[4] *Helvering v. Le Gierse*, 312 U. S. 531, 539 (1941). It is respectfully suggested that the indispensable legal element of insurance is risk-shifting; and that risk-distributing almost always accompanies commercial insurance merely because it is economically the soundest way for an insurer to provide for payment of the risks that have been shifted to it.

ance" when used in the insurance laws of the District of Columbia without statutory definition, that court said:

> "It is unnecessary for us to attempt formulation of an all-inclusive or exclusive definition of insurance or of indemnity, or to distinguish them sharply. While the basic concepts are not identical and each has varied legal usages, they have common and primary elements which are controlling here. Fundamentally each involves contractual security against anticipated loss. Whether the contract is one of insurance or of indemnity there must be a risk of loss to which one party may be subjected by contingent or future events and an assumption of it by legally binding arrangement by another. Even the most loosely stated conceptions of insurance and indemnity require these elements. Hazard is essential and equally so a shifting of its incidence. If there is no risk, or there being one it is not shifted to another or others, there can be neither insurance nor indemnity. Insurance also, by the better view, involves distribution of the risk, but distribution without assumption hardly can be held to be insurance."[1]

Perhaps the best-known and most-quoted common-law definition of "insurance" is that of the Supreme Judicial Court of Massachusetts in the leading case of *Commonwealth v. Wetherbee*, 105 Mass. 149 (1870):

> "A contract of insurance is an agreement, in which one party, for a consideration, (which is usually paid in money, either in one sum or at different times during the continuance of the risk,) promises to make a certain payment of money upon the destruction or injury of something in which the other party has an interest. * * * All that is requisite to constitute such a contract is the payment of consideration by the one, and promise of the other to pay the amount of the insurance upon the happening of injury to the subject by a contingency contemplated in the contract."[2]

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[1] *Jordan v. Group Health Ass'n*, 107 F. 2d 239, 244-245 (1939).

[2] Prior to the enactment of § 41 of the New York Insurance Law defining the term "insurance contract," the New York Court of Appeals, in *Ollendorf Watch Co. v. Pink*, 279 N. Y. 32, 17 N. E. 2d 676 (1938), approved and adopted the Massachusetts common-law definition.

Webster's Collegiate Dictionary (5th ed. 1946) defines "insurance" as:

> "* * * a contract whereby one party undertakes to indemnify or guarantee another against loss by a contingent event; also, *the business of making* such contracts * * *."

Thus, courts and lexicographers are all agreed that in the "commonly accepted sense" the indispensable element of "insurance" is the shifting of a risk of loss, which will be incurred upon the happening of an insurable contingency, from the person subject to such loss to another.[1]

B

A Contract Does Not Become One of "Insurance" Merely Because It Contains Some of the Trappings of Insurance

The cases and authorities discussed above show that the essence of insurance is a risk of loss which is shifted from one person to another. In the absence of this indispensable element the presence in a contract of details customarily associated with insurance cannot make the contract one of insurance no matter how artfully such details may be used. Labels, forms and terms, while they may confound the unwary and uninquisitive, are not controlling.[2]

That the printing of a contract in a form that looks like an insurance policy and the use of insurance terms therein do not make a contract "insurance" was long ago decided by this Court. In *Helvering v. Le Gierse*, 312 U. S. 531, 541 (1941), this Court said:

> "It is true that the 'insurance' contract looks like an insurance policy, contains all the usual provisions of

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[1] Statutory definitions are irrelevant. The Congress or the state legislatures can, of course, define the term in any statute in which they intend that it have meaning other than its "commonly accepted sense."

[2] *Cf. SEC v. C. M. Joiner Leasing Corp.*, 320 U. S. 344 (1943); *SEC v. W. J. Howey Co.*, 328 U. S. 293 (1946).

one * * * [but] * * * Certainly the mere presence of the customary provisions does not create risk * * *."

Contained in the "variable annuity" contract are the terms "Cash Value" and "Policy Loans."[1] In a true insurance contract these values are fixed and guaranteed. In the "variable annuity" contract they have reference to unforeseeable, speculative, non-guaranteed, future current value of "accumulation unit" shares purchased by and credited to the account of the contract holder. The true insurance which *may* be included in VALIC's contract (5-year decreasing term life insurance and permanent and total disability) has no cash or policy loan value (R. 289).

"Incontestability," "Suicide," and "Protection from Creditors" provisions apply only to true life insurance and have no applicability to the "variable annuity" contract.[2] A "Grace Period" is required by law in true insurance contracts for the protection of the insured;[3] in the "variable annuity" it is only an extension of time for payment which contracting parties can, by agreement, insert in any contract. Failure to pay before the end of the so-called "Grace Period" does not terminate the purchaser's participation in the investment fund (as it would forfeit an insurance policy). He retains ownership of the "accumulation unit" shares which he has purchased and their value continues to fluctuate with VALIC's investment experience.

The provisions that are of the essence of the "variable annuity"—"Net Investment Rate and Net Investment Factor," "Accumulation Unit," "Annuity Units," "Annuity Unit Value,"[4] are not found in insurance nomenclature in either form or substance. VALIC's own actuary,

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[1] Pls. Exh. No. 1, pars. 14-15 (R. 572).
[2] Pls. Exh. No. 1, pars. 10, 24, 26 (R. 570, 573, 574).
[3] MACLEAN, LIFE INSURANCE (8th ed. 1957) 178-179.
[4] Pls. Exh. No. 1, pars. 18-21 (R. 573).

who testified that he had been retained by at least 150 insurance companies (R. 523), said that in all his experience he had never seen such terms in an insurance contract (R. 554-555).

Mortality tables, which project rates of death per age group, are complied on the basis of past experience and anticipated increases of longevity. They are used by others than insurers—courts, school boards, public utilities, municipal planners—in forecasting death rates and life expectancy. Insurers use such tables in conjunction with future estimated income (generally referred to as "interest")[1] as a kind of cost accounting device in much the same way that a manufacturer or retailer estimates his costs to fix his selling price (R. 283).[2] The insurer then offers for sale its contract with *guaranteed* insurance coverage for a self-determined consideration. Insofar as an insured in concerned the insurer, upon the occurrence of the contingency insured against, is legally obligated to indemnify him or make payment in the amount specified in the contract notwithstanding that the actual death rate among the insured group may not have agreed with the insurer's estimate made prior to the execution of the contract, or that the insurer may have failed to realize what it had anticipated would be its investment income.[3]

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[1] "The term 'interest' is conventionally used to mean 'income on investment,' although a portion of that income is in other forms, such as dividends or rent" MACLEAN, LIFE INSURANCE (8th ed. 1957) 147, n. 1.

[2] See "Assumptions Underlying Rate Computations" in HUEBNER, LIFE INSURANCE (4th ed. 1950) 194-198.

[3] "* * * a company in computing premiums must estimate its experience for at least twenty years and, in the vast majority of cases, for much longer since the company must continue the contract in force for so long as the insured pays the premiums required by the contract. Furthermore, the company cannot change the premium on any policies in force, and if policies have been issued at inadequate premiums, these contracts must be carried at a loss. If the deficit cannot be made up out of surplus, of course, the company will become bankrupt." HUEBNER, LIFE INSURANCE (4th ed. 1950) 193. Accord, MACLEAN, LIFE INSURANCE (8th ed. 1957) 93-112, 535-539.

To fulfill its contractual obligation to the insured, the insurer is required by the states to comply with a legal reserve system which will demonstrate to the state regulatory body that the insurer has (and keeps) sufficient assets on hand which, with future premium income and an acceptable *specified* rate of investment income, will assure, insofar as law can make it so, that the insurer will be financially able to liquidate its contractual assumption of risks as they come due.[1] The nature and purpose of legal reserves has been succinctly summarized by the Court of Appeals for the District of Columbia Circuit in *Jordan v. Group Health Ass'n*, 107 F. 2d 239, 251 (1939):

> "The object of these [required reserves and regulation of finances] is protection of the insured and thus of the public against the insurer. They assume separateness of identity, with consequent diversity of ownership and possible antagonism of interest between them as well as definite assumption of liability, legally enforceable, by the insurer to the insured. Such re-

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[1] HUEBNER, LIFE INSURANCE (4th ed. 1950) 247 says: "The state, in establishing a method of valuing life insurance contracts, sets certain standards of interest and mortality that can safely be realized and then says, in effect, that any company is solvent if on the basis of calculations made with these standards its future premiums plus its reserve fund will enable it to pay all claims. The minimum standard set by state law in most instances are a 3½ per cent interest rate and mortality according to the *American Experience Table* for policies issued prior to 1948 and the *CSO Table* with 3½ per cent interest for later issues" (italics in original). See also MACLEAN, LIFE INSURANCE (8th ed. 1957) 114-145.

For a technical explanation, with illustrations, of how insurance reserves are computed, see WIGHTMAN, LIFE INSURANCE STATEMENTS AND ACCOUNTS (1952) 559-589.

The "legal standard of valuation" in the District of Columbia provides (§ 35-701 (a), D. C. Code (1951)):

> "The Superintendent shall annually value, or cause to be valued, the reserve liabilities (hereinafter called reserves) for all outstanding life-insurance policies and annuity and pure endowment contracts of every life-insurance company doing business in the District * * *, *specifying* the mortality table or tables, *rate or rates of interest* and methods (net level premium method or other) used in the calculation of such reserves. All such valuations made by him or by his authority, shall be made upon the net premium basis * * *."

VALIC cannot comply with this requirement of law. While its "variable annuity" contract mentions the Progressive Annuity Mortality Table, it does not specify or guarantee any "rate or rates of interest" after the first payment. For this reason it will have to substitute some "artificial assumption" for the "rates" required by the statute (testimony of Hooker, R. 191, 274-275).

quirements can have meaning, purpose and useful effect only in relation to definite and binding obligations as to which, in their absence there is danger of default. They are entirely inappropriate where no such risk is assumed * * *."[1]

VALIC's so-called "reserves" are not absolute in amount based on *fixed* future obligations, but vary with investment experience and investment taxes, for the effect of which VALIC takes no responsibility. They are therefore not insurance reserves.

C

A Life Contingency Factor Does Not Make a Contract "Insurance"

While the uncertainty of duration of life creates insurable contingencies, they cannot be said to be insured against unless the risk of loss to the insured attendant on the happening of the contingency is shifted to and guaranteed by an insurer.

There are many contracts in which a life contingency is a factor in that it is determinative of the term of the contract; *e. g.*, marriage, partnership and employment. No one would say that such contracts are insurance.[2]

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[1] It is common knowledge that the depression of the 30's proved the soundness of legal reserve requirements for life insurance. Notwithstanding the economically disastrous losses in the market value of equities, the business of life insurance was liquid and paid off the guarantees of its contracts; not only losses incurred upon the happening of the contingencies insured against, but also guaranteed policy "cash values" and "loan values".

[2] VALIC's contention that "variable annuity" contracts can be sold only by life insurance companies because they include a life contingency factor is unsupported by Federal law. Insofar as Federal law is concerned the contract, being a security, can be sold by anyone, including life insurance companies, provided he complies with the Federal regulatory scheme which the Congress has established for the protection of the public, the investor and in the public interest. Whether an insurance company is permitted to sell securities is, of course, dependent upon its charter and the various state laws prescribing limitations on activities of such companies. Stock insurance companies offering their own stock for sale to the public through the mails and use of the instrumentalities of interstate commerce comply with the registration requirements of the Securities Act. See Report of the Securities and Exchange Commission on S. 2054 (Feb. 11, 1957), 85th Cong., 1st Sess.

D

Approval of a Contract by an Insurance Commissioner Does Not Make It "Insurance" in the "Commonly Accepted Sense"

Insurance commissioners for the various states are administrative officials having prescribed and circumscribed statutory authority which varies from state to state. What a state, in the exercise of its sovereign power, may choose to encompass within a statutory definition of the term "insurance" need not be confined to the "commonly accepted sense" of the term.

There is nothing in the Federal securities laws or the McCarran-Ferguson Act which even suggests that Congress gave the state insurance commissioners the right to determine that a given contract is one of "insurance" and thereby to exempt it or its issuer from compliance with the securities laws. This would be a most extraordinary power, since it would make state officials (with no jurisdiction over securities) the final arbiters as respects the coverage of the Securities Act and the Investment Company Act. It could hardly have been the intent of Congress that its nationwide securities legislation should govern a contract issued in the state of Connecticut, but should not apply at all to a substantially identical contract issued in the state of Arkansas. We submit that this power cannot be implied. If it had been intended by Congress, it would have been stated in explicit terms.[1]

That the opinion of the Superintendent of Insurance for the District of Columbia is not conclusive as to whether a contract is one of insurance has been firmly established by the Court of Appeals for the District of Columbia Cir-

[1] *Cf. National Casualty Co. v. Federal Trade Commission*, 245 F. 2d 883, 887 (6th Cir. 1957), *aff'd*, 357 U. S. 560 (1958).

cuit. In *Drake v. United States* ex rel. *Bates*, 30 App. D. C. 312, 318-319 (1908), the court, in referring to the powers of the Superintendent, said:

> "It is quite clear that no provision of the law conferred or attempted to confer upon the superintendent of insurance the power to make and enforce an interpretation of the laws relating to insurance companies * * * Such power is a judicial one, that can be exercised by the courts alone."[1]

The court in effect reaffirmed this statement of the law when in 1939 it held that, notwithstanding the Superintendent's conclusion that an appellee corporation was engaged in the business of insurance, he had no jurisdiction because the contracts involved were as a matter of law not "insurance."[2]

This Court, in the *Le Gierse* case and its companion case, held that insurance policies and annuity contracts were not "insurance" notwithstanding that (as the facts of the case show) they had been approved by a state insurance commissioner and sold by an entity chartered as an insurance company.[3]

E

"Variable Annuities" Cannot Be Compared to Participating Insurance Policies

Throughout the years, with changing economic conditions, new and broader types of insurance have been devised and offered for sale by insurers. All these new types, however, possess the indispensable element of risk-shifting, which differentiates "insurance" from "variable annuities."

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[1] The statutory authority of the office of the Superintendent of Insurance is set forth in D. C. Code (1951) §§ 35-101, -102, -401.

[2] *Jordan v. Group Health Ass'n*, 107 F. 2d 239 (1939).

[3] *Helvering v. Le Gierse*, 312 U. S. 531 (1941); *Keller v. Commissioner of Internal Revenue*, 312 U. S. 543 (1941).

Insurance companies are classified as stock or mutual companies.[1] Stock companies "issue chiefly nonparticipating policies (i.e., without dividends to policyholders); but many also issue participating policies (at higher premium rates), most of the surplus earnings from which are paid to the policyholder * * * Mutual companies issue participating policies, which provide for adjustment of cost from surplus earnings (dividends)."[2]

Mehr, an expert witness for VALIC, testified:

> "Now, dividends in a participating company are so ingrained in the ideas of the policyholder that the companies use an interest assumption that will yield a dividend to the policyholder * * *" (R. 470).

Dividends on a participating policy are paid out of surplus funds which may result from, *inter alia,* favorable mortality experience, realization of interest at a rate higher than that assumed, loadings in the premium rate proving to be more than sufficient to provide for expenses and contingencies, and from capital gains.[3] In the insurance business, "the word 'dividend' is to some extent a misnomer, the 'dividend' on a participating policy being rather in the nature of a refund and not a return on an investment as the term is generally used in commercial transactions."[4]

While the amount of "premium" paid by an insured may be reduced by insurance "dividends," this does not affect the risk of loss shifted to and assumed by the insurer (whether it be a stock or mutual company) when it guaran-

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[1] VALIC is a stock company (R. 284). Excerpting from the text of its expert witness Maclean (LIFE INSURANCE (8th ed. 1957) 18): "It is formed primarily for the purpose of earning profits for the stockholders who own and control the company."

[2] MACLEAN, LIFE INSURANCE (8th ed. 1957) 18; accord, HUEBNER, LIFE INSURANCE (4th ed. 1950) ch. XXIX.

[3] MACLEAN, LIFE INSURANCE (8th ed. 1957) 147; HUEBNER, LIFE INSURANCE (4th ed. 1950) ch. XXII.

[4] MACLEAN, LIFE INSURANCE (8th ed. 1957) 148, n. 1; accord, HUEBNER, LIFE INSURANCE (4th ed. 1950) 300.

tees to pay upon the happening of the specified insurable contingency. VALIC did not, and indeed it could not, introduce any evidence to the contrary.

Insurance "dividends" affect premium rates, but have no effect whatever on the risk shifted to the company. Its positive guarantee of payment remains unaffected whether it pays large policy "dividends" or none at all.

VALIC's "variable annuity" investment scheme, which does not provide for risk-shifting, does not affect the consideration paid by the contract holders, but only their entitlements (which are conditioned on VALIC's investment experience). Thus, insurance policies that pay "dividends" and the "variable annuity" scheme cannot be compared.

IV

The "Variable Annuity" Contract is not Insurance Because it Lacks the Indispensable Element of Risk-Shifting

A

The Risk Shifted by Insurance or an Annuity

Insurers, in connection with life insurance and annuity contracts, insure against the hazards attendant on the uncertainties of the life span. The two types of contracts are equated in the insurance concept because of the elements of *certainty* and mortality that inhere in both.

An insurer that sells both life insurance and annuities is selling certainty to its policy holders, despite the fact that each individual has a life of uncertain duration; certainty that the dependents of the insured will have a definite amount of money if he dies; and certainty that

the annuitant will have a *fixed* dependable income after a certain age for the continuing years of his life.[1] From the viewpoint of the insured, life insurance is assurance against loss from early death; annuity, loss from longevity.[2]

Unless the risk of loss attendant on death or longevity is contractually shifted to and assumed by an insurer, the contract, notwithstanding its label or the corporate charter of the issuer or any other criterion, is not insurance. From what source or through what economic methods the insurer acquires the money to meet its contractual obligations is no part of an "insurance" contract. The contract fixes only the insurer's obligation to pay.

B

The "Variable Annuity" Does Not Shift the Risk of Loss Attendant on the Contingency of Longevity

In the accumulation period, during which the purchaser of a "variable annuity" contract is making payments to VALIC, there can be no question that VALIC's operations are those of an investment company. The contract purchaser is then an investor in every sense of the word. The purchaser supplies the capital, purchases shares in an investment fund which he may cash in at any time at current value, and is dependent upon VALIC's exclusive

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[1] Accord, HUEBNER, LIFE INSURANCE (4th ed. 1950) 130-132.

[2] HUEBNER, LIFE INSURANCE (4th ed. 1950) defines "life insurance" and "annuities" thus:

> "From the standpoint of the individual, however, life insurance may be defined as consisting of a contract, whereby for a stipulated compensation, called the premium, one party (the insurer) agrees to pay the other (the insured) or his beneficiary, a *fixed* sum upon the happening of death or some other specified event" (p. 3).
>
> * * *
>
> "An annuity therefore represents the purchase of a *fixed* income (monthly, quarterly, semi-annually, or annually) and the general purpose of the contract is seen to be the reverse of that accomplished under life insurance" (p. 91).

management, operation and control of the fund.[1] The value of his shares fluctuates with the fund's investment experience. It is a purely speculative venture in which the purchaser has only the hope of gain and bears the risk of loss.[2] Does this investment venture become "insurance" because the participant *elects* at a future time to become a party to the "variable annuity" period of the contract? It does not; for if he so elects he agrees to purchase shares ("annuity units") in the same investment fund, at current value, and for the term of the contract (from date of election to date of death of the participant, or other optional term) and VALIC agrees to make him an uncertain payment, the amount of which is dependent upon its future, month to month, investment experience resulting from its exclusive management, operation and control of the investment fund.[3]

The proof is clear that during this "variable annuity" period VALIC does not guarantee that *any* payments will

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[1] VALIC has in the past objected to our characterization of the cash and securities in its hands as a "fund" in which contract holders have aliquot shares. This objection is easily met by reference to VALIC's own sales literature of record herein. See, *e.g.*, Pls. Exh. No. 20, R. 761-767 at 763: "If the equities held in the *fund* increase in market value, the value of the units will be increased proportionately."

[2] Mr. Harry Prankard, with long experience in the investment company business as a certified public accountant and an executive (R. 307-308), demonstrated in his testimony that the formula specified in the "variable annuity" contract for determining the value of shares and the method employed by investment companies have the same end result. VALIC uses percentage increase or decrease; investment companies dollar increase or decrease (R. 309-319).

[3] Compare the classic description of the rights of an insurance policy-holder appearing as follows in *People v. Security Life Ins. & Annuity Co.*, 78 N. Y. 114, 123 (1879):

> "The fund produced by the payment of all the premiums does not in any sense belong to the policy-holders but belongs exclusively to the company; and the policy-holders are interested in it in the same way only that the creditors of any other corporation are interested in its fund"

with the following from the District Court's opinion, 155 F. Supp. at p. 524 (R. 85):

> "Whereas the money paid for conventional insurance becomes the absolute property of the insurance company, the money paid for a variable annuity goes into an investment fund which becomes, by operation of law if not by express terms of the contract, a trust fund for the equitable interests of the contract holders."

See also 8 COUCH, CYCLOPEDIA OF INSURANCE LAW, §§ 2043-2045.

be made to the shareholders or that the capital which they have supplied may not be dissipated by investment losses.

References in VALIC's "variable annuity" contract to the Progressive Annuity Table at 3½% and a provision that payments to shareholders will not be decreased because mortality of shareholders may be less than indicated by the Table are meaningless when analyzed. The Progressive Annuity Table at 3½% is used by VALIC for one purpose only: to determine the first monthly payment to be made to the contract holder, which in all contracts is less than $10 per $1000 of capital investment.[1] From this point on, the impressively voluminous tables of payments set forth in the contract (R. 568-569) have no application. The total *first* monthly payment thus determined is then divided by the current value of an "annuity unit" share and the resulting number of shares is purchased by the investor and credited to his account. Ownership of these shares, with their uncertain future monthly value, is all that the purchaser receives for his capital payment.[2] Subsequent payments for the term of the contract, *if any*, depend upon VALIC's investment experience.[3]

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[1] This could hardly be held to be a substantial risk assumed by VALIC. *Cf. Keller v. Commissioner of Internal Revenue*, 312 U. S. 543 (1941).

[2] Reference to a mortality table is not necessary to effectuate the "variable annuity" scheme. Promoters could establish any arbitrary table of first monthly payment, at any specified age, per $1000 invested and employ VALIC's formula of dividing the total first monthly payment by a current value of "annuity unit" shares and thus determine number of shares purchased. Whether the VALIC formula (which is camouflaged by reference to a mortality table) or an arbitrary table is employed does not affect the principle of the transaction.

[3] VALIC has never earned as much as 3½% on its funds, so far as the record shows (Pls. Exh. No. 4 (R. 647-652)). Counsel for VALIC conceded this (R. 545-546).

If VALIC begins with a fund which with a 3½% "net investment rate" is sufficient to maintain level payments to a group of individuals, then if the net investment return is actually zero instead of 3½%, no investment return will in fact the distributed and the successive payments will become smaller and smaller. Since there is no investment income to be distributed, only the original fund will be distributed; and the original fund will be lessened by VALIC's management fee of 1.8% per annum and such amounts as it may

(Footnote continued on following page.)

A statement in the contract that VALIC guarantees that the dollar value of "annuity unit" shares will not be affected by "variations in mortality experience" (Pls. Exh. No. 1, par. 22 (R. 573)) is redundant.[1] By specific provision in its contract VALIC agrees to make monthly payments on the basis of "annuity unit" shares held times their current value (*Id.*). By operation of this provision VALIC takes the calculated risk that the number of outstanding shares may require it to dip into its surplus, if any, or the capital contributions of its shareholders.[2] This is a risk taken by any entrepreneur; it is not an "insurance" risk in the sense explained in the *Le Gierse* case.[3]

That risk-distributing, even coupled with a life contingency, does not make a contract insurance may be demonstrated by an illustration:

A person who buys a pari-mutuel ticket at a race track participates in a scheme for risk-distribution. If the track

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(Footnote continued from preceding page.)
be required to pay for investment taxes. If there is actual capital loss on investments, in excess of income, then it is obvious that not all of the original fund will in fact be distributed to the contract holders, since part of it will never be available for distribution, having been lost through investment misfortune.

Under the usual form of life annuity contract, so long as the insurer is solvent, the contract holder gets the same payment, no matter what may happen to the insurer's investments. The insurer may become insolvent by reason of adverse investment experience alone, but VALIC can *never* become insolvent by reason of adverse investment experience alone. It is the contract holders who will bear the investment losses; and if these are large enough, the individual's losses contingent upon survival to respective payment dates will not be indemnified as *guaranteed* in an annuity contract.

[1] Such a statement cannot be found in a true annuity or life insurance contract, since the risk of adverse mortality experience is a calculated one taken by an insurer. An insurer's obligation to the insured is contractually fixed upon the happening of the insurable contingency.

[2] The capital contributions of VALIC's stockholders have been invested in securities having a par value of $211,000 which the Superintendent of Insurance has certified "are worth not less than $200,000" (Def. Exh. No. 12 (R. 822)).

[3] "It is not enough to show that the insurance company assumed 'some' risk. A bank assumes a risk when it accepts a depositor's funds and invests them. The investment may prove to be an unsafe one, or the bank may have agreed to pay the depositor a higher rate of interest than it can profitably earn on the funds it invests. Indisputably this is a risk. But it is not a insurance risk in the sense explained in the *Le Gierse* case." *Keller v. Commissioner of Internal Revenue*, 312 U. S. 543, 544 (1941).

should require, as a condition of collecting (should he prove lucky enough to have his horse win), that he be alive and personally present the ticket at the pay-off window, he would also participate in a scheme involving a life contingency. But it would not be insurance. VALIC's "variable annuity" contract differs in detail but not in substance from the illustration. Both entail speculation—in the pari-mutuel on a horse winning a race; in the "variable annuity" on VALIC's good luck or skill with its investments. In both, the availability of a sum to collect is contingent not on survival alone but on a speculative chance as well. In both, the amount collected, *if any*, is not related to or indemnification for any loss occasioned by the insurable contingency of continuing life beyond a specified age.

In the "variable annuity" period the "annuity unit" shareholder is not assured that he will have a fixed, dependable income, or any income, from his "variable annuity" for the remainder of his life. He foregoes this benefit in return for the gamble that he will realize from the speculative "variable annuity" scheme a return greater than that he would be guaranteed under a conventional annuity. As a part of the gamble he remains subject not only to the risk of loss attendant on longevity, but also loss of his capital investment. Both lower courts recognized this.[1]

VALIC has been heard to argue that the contract it sells is an "annuity" because the death of the purchaser, a short time after he *elects* to participate in the "variable annuity" period, will prevent his receiving more than a nominal return of his capital. VALIC asserts that this is one of the characteristics of "insurance." This is superficial. The purchaser of an "annuity" buys guaranteed

[1] See Statement of Facts, *supra*, at pp. 17-19.

protection. He is willing to take the financial risks of early death in return for the guarantees of an insurer. The purchaser of a "variable annuity," however, gets no guaranteed protection. He takes a chance whether he is going to die immediately or live for many years.

"Risk-shifting" is legally indispensable to insurance. The potential loss which a conventional annuity shifts to an insurer is not shifted to or assumed by VALIC. The purchaser of VALIC's "variable annuity" contract remains saddled with the risks of longevity risks of equity ownership. Therefore, the "variable annuity" contract is not insurance.

V

The "Variable Annuity" is not an Annuity Contract

We have shown above that the "variable annuity" contract is not insurance. Neither is it an "annuity contract" within the meaning of § 3(a)(8) of the Securities Act of 1933.[1] The same rules of statutory construction apply to this term as to the term "insurance": each was used by Congress "in its commonly accepted sense."

The essence of an *annuity* is (a) periodic payment *of* (b) a *fixed* sum. The authorities to this effect have recently been assembled and reviewed at length in connection with "variable annuities."[2] At this point we need cite only two of the historical and one of the recent definitions of "annuity."

In *Booth v. Ammerman*, 4 Bradford Surr. 129 (N. Y. 1856), the testator had bequeathed to A "the interest upon

[1] Appendix A, *infra*, p. 58.

[2] See *Bellinger, et al.*, "The Meaning and Usage of the Word 'Annuity'" 9 Journal of the American Society of Chartered Life Underwriters (1955) 261, for citation and discussion of the relevant case law and standard insurance texts.

$1500," payable annually during her widowhood. The Court held that this bequest was *not* an *annuity,* saying (at pp. 133-134):

> "An annuity is a stated sum per annum, payable annually unless otherwise directed. It is *not* income or *profits,* nor *indeterminate* in amount varying according to the income of profits, though a certain fund may be provided, out of which it is to be payable * * *"
>
> [If the payment] "is not a stated sum, but may be more or less, according to the earnings of the capital * * * it does not possess the characteristic of an annuity * * *"

This definition has frequently been adopted and repeated in later decisions, both in New York and in other jurisdictions.

In *Peck v. Kinney,* 143 Fed. 76, 80 (2d Cir. 1905), the court, determining whether a property interest should be taxed as a life estate or an annuity, held that an *annuity* had been created because:

> "The essential element is the certainty of the amount to be paid periodically at a certain rate per annum or in a certain aggregate annual amount."[1]

In 1957 the Supreme Court of Errors for the State of Connecticut expressed itself clearly to the same effect in connection with "variable annuities":

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[1] The State of New York now has a statutory definition which reads:

> "'Annuities' meaning all agreements to make periodical payments where the making or continuance of all or of some of a series of such payments, or the amount of any such payment, is dependent upon the continuance of human life, except payments made under the authority of paragraph one." N. Y. Insurance Law § 46, subdivision 2.

In construing and applying this statutory definition, the Supreme Court of New York, recognized the distinction between the definition and the commonly accepted meaning of the term "annuity" when it stated:

> "The Court agrees with the Attorney General's statement that 'The words "periodical payments" do not necessarily entail only fixed sums payable on specified dates'." *In re Supreme or Cosmopolitan Council of Brotherhood of Commonwealth,* 193 Misc. 996; 86 N. Y. S. 2d 127, 130 (1938).

VALIC's reliance on this case as support for its argument that it offers an "annuity" in the ordinary sense of the word is therefore mistaken.

> "* * * the dollar return from the annuity units would fluctuate with the value and the amount of return from the corpus of the fund from which the annuities are paid. We have said that an annuity is a yearly payment of a certain sum of money granted to another in fee, or for life, or for a term of years, charging the person of the grantor only. It is a stated sum payable annually. [Cases cited.] Insurancewise, it has the same meaning. 1 Appleman, Insurance Law & Practice, Secs. 81; 1 Couch, Insurance, p. 38. The policy to be issued under the [variable] annuity option would provide for the payment, not of a fixed amount of money, but of an uncertain sum, which is quite different from the legal concept of the word 'annuity'."[1]

The term "annuity," by established definition and long usage, has thus been universally understood to denote *a fixed sum payable periodically.* Since a "fixed sum" cannot be a "variable sum," the coined name "variable annuity" presents a contradiction in terms.

VI

The "Variable Annuity" Contract and its Issuers are not Exempted From Compliance With the Federal Securities Laws by Those Laws or by the McCarran-Ferguson Act

A

The Securities Laws

Section 3(a)(8) of the Securities Act of 1933[2] and § 3(c)(3) of the Investment Company Act of 1940, which must be read with the definition of "insurance company" in § 2(a)(17) of that Act,[3] list conjunctive conditions that must be met to qualify for exemption.

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[1] *Spellacy v. American Life Ins. Ass'n*, 144 Conn. 346, 355, 131 A. 2d 834, 839.

[2] Appendix A, *infra*, p. 58.

[3] Appendix A, *infra*, p. 62.

In the Securities Act these conditions are:

1. The contract must be an "insurance policy" * * * or "annuity contract" * * *; *and*

2. Issued by "a corporation subject to the supervision of the insurance commissioner * * * of any State * * * or the District of Columbia."

In the Investment Company Act it is required that an "insurance company," to be exempt under § 3(c)(3), meet the definition of that term in § 2(a)(17) of the Act, which provides that:

1. The company must be "organized as an insurance company," *and*

2. The company's "primary and predominant business activity [must be] the writing of insurance * * *," *and*

3. The company must be "subject to supervision by the insurance commissioner of a State * * *."

VALIC and its "variable annuity" contract fail to qualify for exemption under either Act because:

A. Under the Securities Act the "variable annuity" is neither "insurance" nor an "annuity contract" within the meaning of those terms as used in the Act, and

B. Under the Investment Company Act VALIC's admittedly "primary and predominant business activity" is "the offering for sale" and sale of "variable annuity" contracts, not "the writing of insurance."[1]

[1] It is conceded that VALIC is chartered as an insurance company.

B

The Offering for Sale and the Selling of "Variable Annuity" Contracts is Not "The Business of Insurance"

The McCarran-Ferguson Act exempts from Federal regulation, in a consistently repeated phrase of limitation, "*the business of insurance.*" Research has failed to disclose any reported case in which the meaning of the phrase was at issue or construed by the Federal Courts. Neither the Act nor its legislative history defines it.[1]

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[1] The impetus giving rise to consideration by the Congress and eventual passage of the McCarran-Ferguson Act was the decision of this Court in *United States v. South-Eastern Underwriters Assn.*, 322 U. S. 533 (1944). In that case the Court in effect overturned *Paul v. Virginia*, 8 Wall. 168 (1869), and a line of related subsequent cases which held that contracts of insurance are not commerce.

Relying on *Paul v. Virginia*, in the period from 1869 to 1944, the business of insurance, as conducted by insurance companies, involved practices concerning which the Congress had legislated in the exercise of its powers under the commerce clause.

The confusion and uncertainty in the insurance business generated by the *South-Eastern* case which the Congress felt compelled to remedy is best described by the following excerpts from the reports of the committees of both Houses of Congress:

> "Inevitable uncertainties which followed the handing down of the decision in the *Southeastern Underwriters Association* case, with respect to the constitutionality of State laws, have raised questions in the minds of insurance executives, State insurance officials, and others as to the validity of State tax laws as well as State regulatory provisions; thus making desirable legislation by the Congress to stabilize the general situation.
>
> "Bills attempting to deal with the problem were considered in both the House and the Senate during the Seventy-eighth Congress, but failed of enactment. Your committee believes there is urgent need for an immediate expression of policy by the Congress with respect to the continued regulation *of the business of insurance* by the respective States. Already many insurance companies have refused, while others have threatened refusal to comply with State tax laws, as well as with other State regulations, on the ground that to do so, when such laws may subsequently be held unconstitutional in keeping with the precedent-smashing decision in the *Southeastern Underwriters* case, will subject insurance executives to both civil and criminal actions for misappropriation of company funds." [S. Rep. No. 20, 79th Cong., 1st Sess., 1-2; H. R. Rep. No. 143, 79th Cong., 1st Sess., 2.]

Further, the House Report accompanying the legislation flatly stated:

> "*It is not the intention* of Congress in the enactment of this legislation to clothe the States with any power to regulate or tax *the business of insurance* beyond that which they had been held to possess prior to the decision of the United States Supreme Court in the South Eastern Under-

(Footnote continued on following page)

The McCarran-Ferguson Act was enacted in 1945. Its title states that it is "An Act to express the intent of the Congress with reference to the regulation of *the business of insurance.*"

Under these circumstances, the term "insurance" was obviously used by the Congress in its "commonly accepted sense." From this it logically follows that "the business of insurance" is the offering for sale and selling of contracts whereby the offeror undertakes to indemnify or guarantee another against loss by a contingent event. Inasmuch as VALIC's "variable annuity" contracts provide no such undertaking, the offering for sale and selling of such contracts cannot be held to be "the business of insurance." Therefore, VALIC cannot be held to qualify for exemption from Federal regulation by virtue of the McCarran-Ferguson Act, the applicability of which is expressly confined to "the business of insurance."

VII

The Lower Courts Misapplied Controlling Statutes in Exempting VALIC and the "Variable Annuity" Contract

The Findings of Fact of the trial court, in the light of existing law, show beyond question that it and the Court of Appeals erred in their conclusion that VALIC and its "variable annuity" contract are exempt from compliance with the Federal securities laws.

(Footnote continued from preceding page)
writers Association case." H. R. Rep. No. 143, 79th Cong., 1st Sess., 3.; see also 91 Cong. Rec. 1443.

The legislative history of the McCarran-Ferguson Act is found in the following: H. R. 3270 and S. 1362, 78th Cong., 1st Sess. (1943). Hearings Before Joint Subcommittees on the Judiciary on S. 1362, H. R. 3269 and H. R. 3270, H. R. Rep. No. 873, S. Rep. No. 1112; H. R. Rep. No. 68, 79th Cong., 1st Sess. (1945); S. Rep. No. 20, 79th Cong., 1st Sess. (1945); H. R. Rep. No. 143, 79th Cong., 1st Sess. (1945); and 91 Cong. Rec. 499-509, 1112-1122, 1443, 1470-1473, 1548-1559 (1945).

A

The District Court

We repeat that in its opinion the District Court said:

> "The logic of the law applied to the established facts seems to bring the variable annuity contract within the purpose and intendment of the Securities Act, and the defendants [VALIC and EALIC] within the terms and plan of the Investment Company Act. This Court would feel constrained to so hold if it were not for the clear and explicit language of the McCarran Act and the fact that the defendants are licensed and registered by the Insurance Department of this District and the States where they operate."[1]

Then without making a finding that the "variable annuity" contract is "insurance" (the opinion implies that it is not)[2] and its sale "the business of insurance" the court concluded that because: (1) VALIC and EALIC are chartered as insurance companies; and (2) the contracts have been approved by the insurance commissioners of the District of Columbia and three states:

> "* * * this Court is constrained to hold that the broad, explicit and impelling language of the McCarran Act makes them exempt from Federal regulation unless and until Congress provides otherwise."[3]

As shown, *supra*, pp. 51-52, the McCarran-Ferguson Act applies only to "the business of insurance." It does not provide expressly or by implication that:

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[1] 155 F. Supp. at p. 526 (R. 89).

[2] The District Court, toward the end of the trial, stated in effect that the "variable annuity" was not insurance but that the ultimate issue was what agency such contracts were to be regulated by. The court said:

> "* * * I think, there is a decided legal difference between the old line policy and your [VALIC's] new policy.
>
> "I am not deciding the ultimate question as to what agency are you [VALIC] amenable for regulation * * *." (R. 559).

Clearly the court confused the issue raised by the pleadings. It did not decide the basic issue as to whether the contracts are "insurance." Applicable regulation flows from this, not this from the regulation.

[3] 155 F. Supp. at p. 527 (R. 90-91). See also Conclusions of Law (R. 112).

(1) insurance companies are exempted from Federal regulation; or

(2) a state insurance commissioner's approval of a contract is conclusive that the contract is "insurance" and its sale "the business of insurance."

If the Congress intended that such criteria should be controlling it would easily have said so. Instead, by consistent repetition in the statute the Congress confined its applicability to "*the business of insurance*" and nothing else.

To hold that simply because an entity is chartered as an insurance company it can avoid Federal regulation of *any* activity that it can persuade a state insurance commissioner to approve is incompatible with the language and purpose of the Act. It would make any *one* insurance commissioner the arbiter of Federal jurisdiction insofar as insurance companies are concerned.[1]

B

The Court of Appeals

The Court of Appeals premised its affirmance on these statements:

1. The opinion of four insurance commissioners "that the business of VALIC is the business of insurance, is important"; and "we should not contradict the insurance commissioners";[2]

2. "The definitions in the Securities Act and the Investment Company Act indicate that if the insurance com-

[1] If the "variable annuity" contract is insurance it is exempted from Federal securities regulation by §3(a)(8) of the Securities Act. Reference to the McCarran-Ferguson Act is not needed. If the contract is not "insurance" within the meaning of the Securities Act, then, certainly, its sale is not "the business of insurance."

[2] 257 F. 2d at pp. 204, 205 (R 891, 893).

missioner of a state subjects the business to his supervision, it is the business of insurance."[1]

We have already shown that 1, above, is of no probative value in resolving the issue of exemption from the Federal laws unless the contracts are "insurance" within the commonly accepted sense of the term.[2] Counsel for VALIC admitted this when, in conceding that there is disagreement in the insurance industry as to whether the "variable annuity" is a proper product to be sold by life insurance companies, he stated to the trial court that "this case is not going to be decided by a show of hands of Insurance Commissioners" (R. 518-519).[3] Likewise we have shown that the definitions in the Acts named in 2, above, require conjunctive conditions for qualifying for exemption and that one of the indispensable conditions in both Acts is that the contracts be "insurance." The court made no finding that this condition was satisfied. Contrariwise, the court implicitly found that the "variable annuity" contracts are not "insurance" when it could go no further than to say that the contract is a "novel" arrangement[4] which "resembles insurance" and its sale a "new business."[5]

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[1] 257 F. 2d at p. 205 (R. 892).

[2] Regardless of approval of VALIC's "variable annuity" contracts by the insurance commissioner of West Virginia (one of the actions on which both lower courts relied) the Securities Commissioner of that state has brought action to enjoin the sale of such contracts within the state unless VALIC complies with the state's securities laws. *State of West Virginia ex rel. Edgar B. Sims, its Commissioner of Securities v. Variable Annuity Life Insurance Company of America, Inc.*, Circuit Court of Kanawha County, West Virginia, Docket No. 24,449. The case was tried on July 21-22, 1958 and the parties have submitted briefs. The court has the case under advisement.

[3] Compare with a table showing state legislatures in which bills have been introduced to permit insurance companies to sell "variable annuities" (Appendix B, *infra*, p. 67). Not one of the states has enacted such legislation. These bills make it clear that in none of these states do "variable annuities" qualify under general insurance laws:

[4] 257 F. 2d at p. 204 (R. 890).

[5] 257 F. 2d at p. 205 (R. 893).

The court concluded its opinion by suggesting that there is a demand for "variable annuities," and that this "new business" constitutes an "attempt to solve a problem badly in need of solution." This may be entirely true; but it is not relevant to proper disposition of the case. This action is not an attempt to extirpate "variable annuities." Petitioner contends only that these devices should be regulated as other investments are. If there is an economic need for "variable annuities" it can be satisfied within the framework of regulation provided by the Federal securities laws.

CONCLUSION

For the Reasons Stated it is Respectfully Submitted That the Judgment of the Court Below Should be Reversed.

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